# In the Supreme Court of the United States

OCTOBER TERM, 1964

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No. 525

IOWA SOUTHERN UTILITIES COMPANY, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT*

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## MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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In 1943, minority shareholders of the taxpayer, a public utility corporation, instituted a derivative action in the Iowa courts against George M. Bechtel and others, alleging that they had misused their positions in the corporation to sell to the corporation properties which they had earlier acquired secretly

at prices far below those paid by the corporation. In 1952, the Supreme Court of Iowa rendered judgment against the defendants and in favor of the taxpayer corporation in an amount exceeding $2,200,000. *Des Moines Bk. & Tr. Co.* v. *Bechtel & Co.*, 243 Iowa 1007, 51 N.W. 2d 174 (Pet. 2a, 12a-13a). In 1955, the court entered judgment in favor of the attorneys who had prosecuted the case and against the taxpayer corporation in an amount in excess of $160,000. The taxpayer paid this amount and deducted the payment as an ordinary and necessary business expense. The Commissioner disallowed the claimed deduction on the ground that it was a non-deductible capital item (Pet. 2a, 14a-15a).[1] The Tax Court sustained the Commissioner's determination (Pet. 3a, 17a). The court of appeals affirmed, pointing out that the State court litigation, in effect, involved adjustments of the purchase prices of capital assets (Pet. 9a-11a).

The effect of the various property transactions and legal proceedings in this case was that the taxpayer initially paid inflated prices for certain properties and then obtained an adjustment of the price as a result of the derivative suit brought by its shareholders. The legal fees and costs which taxpayer was required to pay to the attorneys who prosecuted the derivative suit were incurred to obtain an adjustment in the price paid for capital assets acquired by the corpora-

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[1] A portion of the claimed deduction which was allocable to certain salary and interest items was allowed and is not involved in the litigation. (Pet. 3a.)

tion. It is well established that legal expenses incurred in obtaining agreement upon or modification of the terms of a sale of capital assets are themselves capital items which are not currently deductible against ordinary income. The seller is required to apply such payments in reduction of any capital gain on the sale or to increase the amount of his loss on the sale. See *Munson* v. *McGinnes*, 283 F. 2d 333 (C.A. 3), certiorari denied, 364 U.S. 880. The buyer must add such expenses to the basis of the property acquired. *Pennroad Corp.* v. *Commissioner*, 21 T.C. 1087, affirmed on another issue, 228 F. 2d 329 (C.A. 3). As the *Munson* and *Pennroad* cases establish, these principles are fully applicable to adjustments in price made in later years as a result of a shareholder's derivative suit.

The decision below is a correct application of established principles. It is not in conflict with any of the decisions discussed by petitioner at pages 4 to 7 of the petition, for none of these involved the determination or adjustment of the terms of sale of a capital asset. In thus distinguishing these cases, we do not mean to imply that we believe each of the decisions is correct, or that all are fully reconcilable in terms of the ultimate principles which should control the capitalization of legal expenses. Our point is only that there is no such immediate or direct conflict in decisions as would warrant review by this Court at the present time. Such review should, we think, await a fuller development of the applicable rules in the lower

courts. It is certainly not required in a case such as this one.[2]

Respectfully submitted,

ARCHIBALD COX,
*Solicitor General.*

NOVEMBER 1964.

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[2] The taxpayer is incorrect in stating (Pet. 7) that under the decision in *Trust of Bingham* v. *Commissioner*, 325 U.S. 365, different criteria are to be applied under Section 162(a) from those under Section 212 for the determination of which expenses must be capitalized. The two sections provide identical classes of deductions with identical limitations except for the requirement under Section 162(a) that the expense be incurred in "a trade or business." See *United States* v. *Gilmore*, 372 U.S. 39, 45; *California and Hawaiian Sugar Refin. Corp.* v. *United States*, 311 F. 2d 235, 244-245 (C. Cl.).

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